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JUN 21 1966
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IN THE

Supreme Court of the United States

October Term, 1965

No. 278

JERALD S. SCHUTZBANK, as Corporations Commissioner of the State of California,

Petitioner,

vs.

PETER M. ELLIOTT, as Trustee in Bankruptcy of the Estate of Van's Market, a copartnership composed of KENNETH M. PRICE and WILLIAM R. BABINEAU, Bankrupt,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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PETER M. ELLIOTT, as Trustee in Bankruptcy of the Estate of Van's Market, a copartnership composed of KENNETH M. PRICE and WILLIAM R. BABINEAU, Bankrupt,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above entitled case on February 9, 1966.

Citations to Opinions Below.

The Findings of Fact and Conclusions of Law [R. 119-122] and the Order [R. 123] of the referee in bankruptcy are unreported and are printed in Appendix B hereto, *infra,* pp. 6-10. The Order on Petitions for Review of Referee's Order of January 6, 1965, of the District Court [R. 79-80] is unreported and is printed in Appendix B hereto, *infra,* p. 11. The Opinion of the Circuit Court of Appeals, printed in Appendix B hereto, *infra,* pp. 13-24, is reported in 356 F. 2d 749.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on February 9, 1966. [R. 139-148, App. B, pp. 13-24, *infra*.] Rehearing was denied on March 22, 1966. [R. 150.] The jurisdiction of this court is invoked under 28 United States Code section 1254(1).

Question Presented.

Whether Section 12300.3 of the California Financial Code which (without reference to the solvency or insolvency of the agent of a check seller) impresses a statutory trust upon all the assets of the agent in favor of the check seller and casher where the agent commingles funds received from the sale of checks (and held in trust) with his own assets is in such conflict with Section 64 of the Bankruptcy Act, which sets forth priorities among general creditors, or Section 67-(c)(2) of the Bankruptcy Act, which invalidates certain statutory liens for debts, that it cannot be given effect in the event of the bankruptcy of the agent subsequent to the commingling and the establishment of the trust.

Statutes Involved.

The statutory provisions involved are Sections 64 and 67(c)(2) of the Bankruptcy Act (11 U.S. Code §§ 104 and 107(c)(2)) and California Financial Code Section 12300.3. They are printed in Appendix A, *infra*, pp. 1-5.

Statement of Facts.

Van's Market (hereinafter referred to as "Van's") was an agent for the sale of money orders of Security Currency Services, Ltd. [R. 21, lines 10-12] (hereinafter referred to as "Security"), a check seller and

casher licensed by the State of California. Both by agreement [R. 62] and as required by statutes (Cal. Fin. Code § 12300.3) Van's held in trust funds received in the sale of Security money orders.

On October 15, 1963, Van's Market made an assignment of assets for the benefit of creditors to the Credit Managers Association of Southern California. [R. 21, lines 4-8.] At the time of the assignment, it was obliged to hold in trust for Security the sum of $3,109.16, consisting of proceeds from the sale of money orders sold by Van's as agent for Security prior to the date of the assignment. [R. 21, lines 19 and 20.] Of this amount, $1,094.17[1] had been commingled by Van's with its other assets. [R. 140.] Between the date of the assignment and the date Van's filed bankruptcy, these commingled assets were reduced to cash by the Credit Managers Association and were turned over to Elliott, trustee in bankruptcy of Van's, when Van's was adjudicated bankrupt in early 1964. [R. 22, lines 8-12.]

The court below held the $1,094.17 commingled by Van's with its other assets to be an asset of the bankrupt estate of Van's, unless traceable by Security. [R. 147-148.]

The court below pointed out that by impressing a trust on all assets of the agent until the diverted amount was removed therefrom, the statute would relieve check and money order principals from the burden of tracing commingled funds which burden generally falls upon the

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[1]The court below determined that $2,014.99 of the $3,109.16 which was held in Van's checking account at the time of the assignment for benefit of creditors was an identifiable and traceable trust *res* under California law and affirmed the trial court's judgment awarding it to Security. [R. 145.] Petitioner does not complain of this determination.

beneficiary of a trust. It went on to hold that the provisions of Section 12300.3 of the California Financial Code "insofar as they would establish a trust on the commingled funds, are in such conflict with the federal bankruptcy scheme that they cannot be given effect in the case at bar." *Elliott v. Bumb,* 356 F. 2d 749, 755 (9th Cir. 1966). The court then remanded the matter to afford Bumb, trustee in bankruptcy of Security, the opportunity to trace the sources of the commingled funds.

Reasons for Granting the Writ.

In the court below, a state statute has been struck down for conflict with the Bankruptcy Act.

The court below considered a state statute which, without regard to solvency, eliminated the requirement of tracing a trust *res* in the situation where the agent of a check seller commingled his receipts held in trust as agent with his own funds and concluded that the statute was unenforceable when the bankruptcy of the agent intervened because it was in conflict with the "federal bankruptcy scheme." Particularly, the court appears to find a conflict with Sections 67(c)(2) and 64(a) of the Bankruptcy Act and a rule which is nowhere articulated in the Bankruptcy Act that a beneficiary of a trust where the trustee is a bankrupt can only recover that which is traceable from the trust corpus. *Elliott v. Bumb, supra,* 356 F. 2d 749, 754-755 (9th Cir. 1966).

Section 67(c)(2) has no application to the case at bar because, first of all, it only invalidates statutory liens for *debts.* The relationship between Van's Market and Security Currency is not that of debtor-creditor but

that of trustee-beneficiary such as exists between an agent and his principal.

The Court of Appeal clearly recognizes that Van's held in trust any funds it received in its sale of money orders for its principal. As the decision points out, this relationship arises not only by contract but also on principles of agency. See *Elliott v. Bumb, supra* at 753-754. The fact that the trustee commingles trust assets with his own does not change the relationship to that of debtor-creditor. *Noble v. Noble,* 198 Cal. 129, 133-134, 243 Pac. 439 (1926); *Gunter v. Janes,* 9 Cal. 643, 659 (1858), ("It is difficult to perceive how, in sound logic or in simple justice, a trustee, by his own voluntary act, may change his capacity, and convert himself into a mere debtor." Burnett, J., on Petition for Rehearing.) Since the invalidating provisions of Section 67(c)(2) are applicable only to statutory liens for debts, *Rochelle v. City of Dallas,* 264 F. 2d 106 (5th Cir. 1959), *cert. denied,* 361 U.S. 827 (1959); *In re Baron,* 165 F. Supp. 186, 188 (D. Conn. 1958), it has no application to the case at hand.

Secondly, Section 67(c)(2) only invalidates statutory *liens* and does not invalidate statutory *trusts.* The Court of Appeals, however, treats these the same even though Congress when it last amended Section 67(c) in 1952 (66 Stats. 427) was aware that the phrase in Section 67(c)(2) "statutory liens" had been held not to include statutory trusts.[2] Under these circumstances, Congress' failure to specifically include statutory trusts within the language of clause 2 of Section 67(c) and utilization of the already judicially construed

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[2] *In re Heintzelman Const. Co.,* 34 F. Supp. 109 (W.D. N.Y. 1940).

phrase of "statutory liens" is a strong indication of its intent to adopt the construction already given. *Shapiro v. United States,* 335 U.S. 1, 16, 68 Sup. Ct. 1375, 92 L. Ed. 1787 (*rehearing denied*), 335 U.S. 836 (1948).

In grounding its opinion on Section 64 of the Bankruptcy Act, the court below applied to a trust fund a section of the Bankruptcy Act limited in scope by its very terms to the establishment of priorities among unsecured creditors to the general assets of the bankrupt and totally without application to trust funds which never become a part of the estate of the bankrupt. See *Elliott v. Bumb, supra,* 356 F. 2d 749, 753 (9th Cir. 1966) ("property which is held by him [the bankrupt] in trust belongs to the beneficiary of the trust.").

Similarly, there is nothing in the Bankruptcy Law which generally requires that there be a specific tracing before a trust beneficiary can be made whole. The Court of Appeal specifically recognized the general rule that "the question of whether a trust is established is one to be resolved by the application of state law," citing *Jaffke v. Dunham,* 352 U.S. 280, 281, 77 Sup. Ct. 307, 1 L. Ed. 2d 314 (1957). See *Elliott v. Bumb, supra,* 356 F. 2d 749, 753 (9th Cir. 1966).

Many jurisdictions, as a matter of common law, hold that a trustee who uses trust assets to pay his own debts holds all his other assets in trust for the beneficiary of the trust to the extent that trust assets were diverted from the trust, thus eliminating any requirement of tracing. See Bogert, *Trust and Trustees* (2d Ed.

1965) § 922, pp. 309-320. There is nothing in the bankruptcy cases to indicate that this state trust law is not followed—nor is there anything in the cases to indicate that, merely because such a rule is established by a state statute in a particular area, the rule shall not be followed. The Court of Appeals relies on two cases (*John Deere Plow Co. v. McDavid,* 137 Fed. 802, 812 (8th Cir. 1905) and *In re J. M. Acheson Co.,* 170 Fed. 427 (9th Cir. 1909)) as establishing that tracing is always required in the federal bankruptcy scheme. Both of these cases, however, were decided not on a state law (as is required except when in conflict with a federal law) but upon general federal decisions in equity, the cases arising before the United States Supreme Court issued its decision in *Erie R. Co. v. Tompkins,* 304 U.S. 64 (1938). Compare *In re Tate-Jones & Co.,* 85 F. Supp. 971, 979-980 (W.D. Pa. 1949).

Conclusion.

California Financial Code Section 12300.3 was designed to preserve the integrity of trust funds rather than give the check seller and casher any priority in general assets of the agent. If the agent of a check seller commingles funds which he holds in trust with his own assets, the section impresses a trust upon all the assets of the agent in the amount of the funds diverted from the trust, which impressed trust continues until said amount is deposited in the trust account of the check seller and casher.

For the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A.

Financial Code.

§ 12300.3 Trust funds; deposit; commingling; amount of trust account.

All funds received by a licensee or its agents from the sale of checks, drafts, money orders, or other commercial paper serving the same purpose and for the purpose of paying bills, invoices, or accounts of an obligor, equal in amount to the face value of such instruments or equal to the amount to be paid, shall constitute trust funds owned by and belonging to the person from whom they were received or a licensee who has paid the checks, drafts, money orders or other commercial paper serving the same purpose, for which the funds of such persons have been received by the agent but not transmitted to such licensee or deposited in the trust account of such licensee. If a licensee or an agent of a licensee shall commingle such funds with those of his own, all assets of such agent shall be impressed with a trust in favor of said purchaser or the licensee in an amount equal to the aggregate funds received or which should have been received by the agent from such sale. Such trust shall continue until an amount equal to said funds is separated from those of the agent and transmitted to the licensee or deposited in the trust account of licensee. An amount equal to all such trust funds shall be deposited in a bank or banks in an account or accounts in the name of the licensee designated "trust account," or by some other appropriate name indicating that the funds are not the funds of the licensee or of its officers, employees, or agents. Such funds, or, in the event of the commingling of such funds by licensee or its agent with those of the licensee or its

agent, an amount of funds of such licensee or of its agent equal thereto, shall constitute trust funds as herein provided and shall not be subject to attachment, levy of execution or sequestration by order of court except by a payee, or bona fide assignee, or bona fide holder in due course of a check, draft, or money order sold by a licensee, or except by an obligor for whom a licensee is acting as an agent in paying bills. Funds in said account, together with funds and checks on hand and in the hands of agents held for the account of the licensee, at all times shall be at least equal to the aggregate liability of the licensee on account of checks sold and bills, invoices, and accounts accepted for payment.

Nothing in this law shall be construed to prevent a purchaser, a holder in due course, the payee of a check, draft or money order sold by the licensee in the usual course of his business, or an obligor for whom the licensee is acting as an agent in paying bills of the obligor, from taking any legal action necessary to enforce any claims which said purchaser, holder in due course, payee, or obligor may desire to take including the right to levy attachment or execution.

In the event a license under this law shall be suspended or terminated the licensee shall immediately deposit in said trust account an amount which with funds therein contained shall be equal to the outstanding checks sold and bills unpaid. (Added Stats.1963, c. 1817, p. 3745, § 6.)

Section Sixty-Four (11 U.S.C. § 104).

§ 64. Debts Which Have Priority. a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment shall be (1) the costs

and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; the fees for the referees' salary and expense fund; the filing fees paid by creditors in involuntary cases or by persons other than the bankrupts in voluntary cases; where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, is recovered for the benefit of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors, the reasonable costs and expenses of the recovery; the trustee's expenses in opposing the bankrupt's discharge or in connection with the criminal prosecution of an offense punishable under chapter 9 of title 18 of the United States Code, or an offense concerning the business or property of the bankrupt punishable under other laws, Federal or State; the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the bankrupt in voluntary and involuntary cases, and to the petitioning creditors in involuntary cases, and if the court adjudges the debtor bankrupt over the debtor's objection or pursuant to a voluntary petition filed by the debtor during the pendency of an involuntary proceeding, for the reasonable costs and expenses incurred, or the reasonable disbursements made, by them, including but not limited to compensation of accountants and appraisers employed by them, in such amount as the court may allow. Where an order is entered in a proceeding under any chapter of this Act directing that bankruptcy be proceeded with, the costs and expenses of administration incurred in the ensuing bankruptcy proceeding

shall have priority in advance of payment of the unpaid costs and expenses of administration, including the allowances provided for in such chapter, incurred in the superseded proceeding and in the suspended bankruptcy proceeding, if any; (2) wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; and for the purposes of this clause, the term "traveling or city salesman" shall include all such salesmen, whether or not they are independent contractors selling the products or services of the bankrupt on a commission basis, with or without a drawing account or formal contract; (3) where the confirmation of an arrangement or wage-earner plan or the bankrupt's discharge has been refused, revoked, or set aside upon the objection and through the efforts and at the cost and expense of one or more creditors, or, where through the efforts and at the cost and expense of one or more creditors, evidence shall have been adduced resulting in the conviction of any person of an offense under Chapter 9 of Title 18 of the United States Code, the reasonable costs and expenses of such creditors in obtaining such refusal, revocation, or setting aside, or in adducing such evidence; (4) taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof: *Provided,* That no order shall be made for the payment

of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court: *And provided further,* That in case any question arises as to the amount or legality of any taxes, such question shall be heard and determined by the court; and (5) debts owing to any person, including the United States, who by the laws of the United States in * entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law: *Provided, however,* That such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupancy of the premises affected, and which accrued within three months before the date of bankruptcy.

Section Sixty-Seven(c)(2) (11 U.S.C. § 107(c)(2)).

* * * * *

(2) the provisions of subdivision b of this section to the contrary notwithstanding, statutory liens created or recognized by the laws of any State for debts owing to any person, including any State or any subdivision thereof, on personal property not accompanied by possession of, or by levy upon or by sequestration or distraint of, such property, shall not be valid against the trustee.

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*So in original.

APPENDIX B.

Findings of Fact and Conclusions of Law Re Security Currency Services et al.

United States District Court, Southern District of California, Central Division.

In the Matter of Van's Market, a copartnership composed of Kenneth M. Price and William R. Babineau, Bankrupt. In Bankruptcy No. 163,940-TC.

The matter of the trustee's Application and Order to Show Cause on Credit Managers Association of Southern California and A. J. Bumb, as trustee in bankruptcy of the Estate of Security Currency Services, Ltd., and the Division of Corporations of the State of California, having come on regularly for hearing before the undersigned Referee in Bankruptcy in his Courtroom, on the 12th day of November, 1964, and a written Stipulation of Facts, having been filed herein, duly signed by all parties of interest or their counsel of record, and the matter having been submitted upon said Stipulation of Facts and Points and Authorities filed by various parties of interest; the Court being fully advised in the premises and good cause appearing therefor, now makes its Findings of Fact and Conclusions of Law, as follows:

FINDINGS OF FACT

I.

That the within proceeding was instituted by the filing of an involuntary petition on November 19, 1963, and thereafter, the above captioned partnership was adjudged a bankrupt on March 5, 1964. That Peter M. Elliott is the duly appointed, qualified and acting trustee of the above captioned estate.

II

That on October 15, 1963, the within bankrupt executed a general assignment for the benefit of its creditors to respondent, Credit Managers Association of Southern California, a California corporation, hereinafter referred to as CMA, and as of that date ceased to do business.

III

That the within bankrupt was, at all times mentioned herein, an agent of Security Currency Services, Ltd., for the purpose of selling money orders or checks.

IV

That for the period preceding October 15, 1963, there is due from the bankrupt to Security Currency Services, Ltd., the sum of $3,092.99, representing proceeds from the sale of money orders and checks sold by the within bankrupt as agent for Security, and the additional sum of $16.17, representing fees for the sale of checks, making a total obligation due from the within bankrupt to Security in the sum of $3,109.16.

V

That Security Currency Services, Ltd., honored and paid all checks or money orders from which the above proceeds arose.

VI

That Security Currency Services, Ltd. filed a petition under the terms of Chapter XI of the Bankruptcy Act on January 16, 1964, and respondent, A. J. Bumb was appointed receiver therein, although as the answer of said respondent, on file herein, points out, said A. J. Bumb is now trustee in bankruptcy, rather than receiver of the Estate of Security Currency Services, Ltd., in Bankruptcy No. 166,114-TC

VII

That respondent CMA is presently holding the sum of $2,014.99, which represents monies which were on deposit in the within bankrupt's bank account prior to October 15, 1963, at Bank of America, Harbor and Palm Branch, Los Angeles, and which represented money orders sold by the within bankrupt for Security.

VIII

That the difference between the aforementioned sum of $3,109.16 and the aforementioned sum of $2,014.99 was commingled by the within bankrupt with its other assets which were liquidated by CMA as assignee and the proceeds in the sum of $2,987.56 were turned over to the trustee by CMA.

IX

That respondent, the California Corporations Commissioner, asserts no claim to the funds held by the trustee herein and CMA, but is charged with the responsibility of enforcing the Check Sellers and Cashers Law set forth in Section 12000, et seq. of the Financial Code of the State of California.

X

That likewise, CMA asserts no claim to said funds but seeks a determination by this Court as to what should be done with the funds held by them.

XI

That Sections 12300.3 and 12300.4 of the Financial Code of the State of California create a statutory trust.

CONCLUSIONS OF LAW

I

That Sections 12300.3 and 12300.4 of the Financial Code of the State of California create a statutory trust

in favor of Security Currency Services, Ltd., to the extent of the aforementioned sum of $3,109.16, including the aforementioned sum of $2,014.99 held by CMA.

II

That statutory trusts should be treated the same as statutory liens.

III

That the statutory trust so created as aforesaid when treated the same as a statutory lien is subject to the provisions of Section 67(c) of the Bankruptcy Act, covering statutory liens on personal property not accompanied by possession of, or by levy upon or by sequestration or distraint of, such property.

IV

That the statutory trust so created, as aforesaid, in favor of Security Currency Services, Ltd. is of a class covered by Section 67(c)(2) of the Bankruptcy Act and therefore since it has been determined that said trust should be treated the same as a lien, said trust is wholly invalid against the trustee herein, pursuant to Section 67(c)(2) of the Bankruptcy Act, as *distinguished* from Section 67(c)(1) of the Bankruptcy Act which merely postpones statutory liens, not accompanied by possession, etc., to the payment of those items enumerated in Section 64(a)(1) and 64(a)(2) of the Bankruptcy Act.

V

That therefore Security Currency Services, Ltd. is merely a general unsecured creditor herein in the amount of $3,109.16, and the funds held by CMA should be turned over to the trustee herein.

Dated: January 6, 1965.

ROBERT B. POWELL
Referee in Bankruptcy

Dec. 30, 8:28

Order Re Security Currency Services et al.

United States District Court, Southern District of California, Central Division.

In the Matter of Van's Market, a copartnership composed of Kenneth M. Price and William R. Babineau, Bankrupt. In Bankruptcy No. 163,940-TC.

In accordance with the Findings of Fact and Conclusions of Law, the Court being fully advised in the premises, and good cause appearing therefor,

It is Hereby Ordered, Adjudged and Decreed that any trust created in favor of Security Currency Services, Ltd., pursuant to Sections 12300.3 and 12300.4 of the Financial Code of the State of California be, and the same hereby is, adjudged to be wholly invalid against the trustee herein, pursuant to Section 67(c)(2) of the Bankruptcy Act.

It Is Further Ordered, Adjudged and Decreed that the funds held by the trustee herein and the sum of $2,014.99 held by the Credit Managers Association of Southern California be, and the same hereby are adjudged to be assets of the within estate, free and clear of any right, title, lien or other interests whatsoever, in favor of Security Currency Service, Ltd.

It Is Further Ordered that the Credit Managers Association of Southern California be, and it hereby is, ordered to turn over to the trustee herein, the sum of $2,014.99.

Dated: January 6, 1965.

ROBERT B. POWELL,
Referee in Bankruptcy

Order on Petitions for Review of Referee's Order of January 6, 1965.

United States District Court for the Southern District of California, Central Division.

In the Matter of Van's Market, a copartnership composed of Kenneth M. Price and William R. Babineau, Bankrupt. In Bankruptcy No. 163,940-TC.

This matter having come before the court on petitions of the Corporations Commissioner for the State of California and A. J. Bumb, trustee in bankruptcy of Security Currency Services, Ltd., for review of the Referee's order of January 6, 1965; and the matter having been argued and submitted for decision March 29, 1965, and it now appearing to the court that:

Proceeds from sale of money orders and checks by the bankrupt as agent for Security Currency Services, Ltd., whether deposited to a trust account or commingled with assets of the bankrupt, constitute trust funds [California Financial Code §§ 12300.3, 12300.4];

Said trust funds are not subject to provisions of § 67 (c) of the Bankruptcy Act [11 U.S.C. § 107 (c)]. 4 Collier on Bankruptcy § 70.25, pp. 1210-1212 (14th ed. 1964):

It Is Now, Therefore, Ordered that the order of the Referee of January 6, 1965, be, and the same hereby is, reversed, and the cause is recommitted for further proceedings consistent herewith.

It Is Further Ordered that the Clerk shall this day serve copies of this Order, by United States Mail, upon the Honorable Robert B. Powell, Referee in Bankruptcy, and upon the attorneys for the intefested parties.

Dated: This 9th day of April, 1965.

THURMOND CLARKE,
United States District Judge

Filed: Apr. 9, 1965.

Entered: Apr. 12, 1965.

Opinion of the United States Court of Appeals.

United States Court of Appeals, for the Ninth Circuit.

Peter M. Elliott, Trustee for Van's Market, etc., Appellant, vs. A. J. Bumb, Trustee for Security Currency Services, Ltd., and Corporations Commission of State of California, Appellees. No. 20,095.

[February 9, 1966]

Appeal from the United States District Court for the Southern District of California, Central Division.

Before: Chambers, Hamley, and Ely, Circuit Judges

Ely, Circuit Judge:

On or about November 15, 1962, a written "Agency Franchise and Trust Agreement" was executed by and between Van's Market and Security Currency Services, Ltd. In the agreement, Security appointed Van's as its "Agent for the purpose of issuing Money Orders" and Van's agreed to hold all proceeds for the face value of money orders issued, plus fifty percent of the fees therefrom, in trust for Security and entirely separate and apart from other funds in Van's possession.[1]

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[1]The agreement provided:

"[1. Agent shall accept responsibility and liability for properly issuing all Money Orders and shall account for and remit all proceeds for face value issued plus 50% of fees therefrom to Security; Agent shall hold all said moneys in trust for Security entirely separate and apart from other funds in possession of Agent until remitted. Agent shall twice weekly render to Security, a true and correct written statement of all funds received to date of report by Agent, accompanied by all said funds. Agent shall be solely and wholly liable and accountable for all moneys received by Agent pursuant to this Agreement up to and until Agent delivers physical possession thereof to Security or its designated depositary. Agent shall maintain accounts and records of all transactions and same shall be maintained by Agent not less than two years from date of said transactions.]".

Neither of the two companies fared well financially. On October 15, 1963, Van's executed a general assignment for the benefit of creditors to the Credit Managers Association of Southern California and ceased to do business. Subsequently, on November 19, 1963, an Involuntary Petition in Bankruptcy was filed against Van's, and it was adjudged a bankrupt on March 5, 1964. Peter M. Elliott is the duly appointed, qualified, and acting trustee of Van's estate. Security filed a petition under the provisions of Chapter XI of the Bankruptcy Act on January 16, 1964, and its bankruptcy was adjudicated. A. J. Bumb is the trustee in bankruptcy for Security.

There is due to Security from Van's the sum of $3,109.16, proceeds from the sale of money orders and checks sold by Van's as agent for Security in the amount of $3,092.99 and an additional sum of $16.17 in fees for the sale of certain checks. The obligation flows from transactions occurring before October 15, 1963, the date of Van's assignment for the benefit of creditors. All the money orders and checks sold by Van's were honored and paid by Security. The Credit Managers Association presently holds $2,014.99 which was on deposit in Van's bank account prior to October 15, 1963 and which was received by Van's from its sale of money orders for Security. The balance due, $1,094.17, was commingled by Van's with its other assets.

Elliott, trustee of Van's, applied for an order that Bumb (Security's trustee), the Credit Managers Association,[2] and the Corporations Commissioner for the

[2]The Credit Managers Association of Southern California asserts no claim to the $2,014.99 held by it but merely seeks a determination as to who they should pay, appellant, or appellee A. J. Bumb.

State of California[3] show cause why orders should not be entered declaring "any statutory lien" in favor of Bumb, Security, or the Corporations Commissioner, with respect to any funds of the estate of Van's, to be null and void pursuant to section 67c(2) of the Bankruptcy Act, 11 U.S.C. § 107(c)(2) (1964),[4] and ordering the Credit Managers Association to remit to Elliott, for Security, the funds which it held. The order to show cause was issued on September 18, 1964, and in answer, Bumb asserted that his claim to the money properly rested upon Security's status as the beneficiary of a trust fund under the express provisions of section 12300.3 of the California Financial Code.[5] He alleged

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[3]The Corporations Commissioner of the State of California asserts no claims to the funds held by appellant nor to the funds held by the Credit Managers Association, but as it is charged with the responsibility of enforcing the Check Sellers and Cashers Law, Cal. Fin. Code §§ 12000, *et. seq.*, it is thus concerned with the interpretation placed upon said law by this court.

[4]"(c) Where not enforced by sale before the filing of a petition initiating a proceeding under this title, and except where the estate of the bankrupt is solvent: . . .

"(2) the provisions of subdivision (b) of this section to the contrary notwithstanding, statutory liens created or recognized by the laws of any State for debts owing to any person, including any State or any subdivision thereof, on personal property not accompanied by possession of, or by levy upon or by sequestration or distraint of, such property, shall not be valid against the trustee: . . ."

[5]"§12300.3

All funds received by a licensee or its agents from the sale of checks, drafts, money orders, or other commercial paper serving the same purpose and for the purpose of paying bills, invoices, or accounts of an obligor, equal in amount to the face value of such instruments or equal to the amount to be paid, shall constitute trust funds owned by and belonging to the person from whom they were received or a licensee who has paid the checks, drafts, money orders or other commercial paper serving the same purpose, for which the funds of such persons have been received by the agent but not transmitted to such licensee or deposited in the trust account of such licensee. If a licensee or an agent of a licensee shall commingle such funds with those of his own, all

that the California statute created a true trust and not a statutory lien which would be unenforceable under section 67c(2) of the Bankruptcy Act. The Referee in Bankruptcy, rejecting Bumb's contentions, held that any trust claimed to have been created in favor of Security pursuant to sections 12300.3 and 12300.4[6] of the Cali-

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assets of such agent shall be impressed with a trust in favor of said purchaser or the licensee in an amount equal to the aggregate funds received or which should have been received by the agent from such sale. Such trust shall continue until an amount equal to said funds is separated from those of the agent and transmitted to the licensee or deposited in the trust account of licensee. An amount equal to all such trust funds shall be deposited in a bank or banks in an account or accounts in the name of the licensee designated 'trust account,' or by some other appropriate name indicating that the funds are not the funds of the licensee or of its officers, employees, or agents. Such funds, or, in the event of the commingling of such funds by licensee or its agent with those of the licensee or its agent, an amount of funds of such licensee or of its agent equal thereto, shall constitute trust funds as herein provided and shall not be subject to attachment, levy of execution or sequestration by order of court except by a payee, or bona fide assignee, or bona fide holder in due course of a check, draft, or money order sold by a licensee, or except by an obligor for whom a licensee is acting as an agent in paying bills. Funds in said account, together with funds and checks on hand and in the hands of agents held for the account of the licensee, at all times shall be at least equal to the aggregate liability of the licensee on account of checks sold and bills, invoices, and accounts accepted for payment.

"Nothing in this law shall be construed to prevent a purchaser, a holder in due course, the payee of a check, draft or money order sold by the licensee in the usual course of his business, or an obligor for whom the licensee is acting as an agent in paying bills of the obligor, from taking any legal action necessary to enforce any claims which said purchaser, holder in due course, payee, or obligor may desire to take including the right to levy attachment or execution.

"In the event a license under this law shall be suspended or terminated the licensee shall immediately deposit in said trust account an amount which with funds therein contained shall be equal to the outstanding checks sold and bills unpaid."

[6]"§12300.4

Prior to such separation and transmittal to the licensee or deposit by its agent such funds received by said agent may be used by said agent for the sole purpose only of the making of change

fornia Financial Code was, as against Van's, wholly invalid and that the funds in question should remain assets of Van's estate, free and clear of any right, title, lien, or other interest whatsoever in favor of the estate of Security. He directed that the $2,014.99 held by the Credit Managers Association be released to Elliott for the estate of Van's. On review, the District Court reversed the Referee's decision, holding that proceeds from the sale of money orders and checks by Van's as agent for Security, whether deposited to a trust account or commingled with assets of Van's, constituted trust funds

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or cashing of checks in the normal course of its business. All such funds received by said agent to the date of deposit or transmittal as required below or an amount equal to such funds must be separated from those of the agent and transmitted to, or deposited in the trust account of, the licensee not less than every third business day. If an agent owns or operates, either directly or indirectly, more than two locations for the sale of checks, drafts, money orders, or other commercial paper serving the same purpose and/or for the receipt of money for the purpose of paying bills, invoices or accounts of an obligor, and handles trust funds in any three-day period equal to or in excess of securities to be deposited as provided in Section 12223, said agent shall transmit to, or deposit in the trust account of, the licensee directly from each such location of such agent such funds not later than the end of the next business day following receipt; such funds to be in form of cash or checks cashed in the normal course of business only.

"Where the total amount of such funds held by an agent does not exceed one thousand dollars ($1,000) in a calendar week, the commissioner may, in his discretion, by written order permit the agent to transmit or deposit such funds in periods in excess of 3 days but not more than 10 days.

"If, after reasonable notice from licensee, an agent shall fail to transmit or deposit the funds, or an amount equal thereto, or to report to the licensee, as herein provided without just cause, or if an agent shall use any of such funds, directly or indirectly, for any purpose other than is permitted herein, licensee shall immediately terminate such agency and within five (5) days thereafter notify the commissioner in writing of the reason for such termination, setting forth the name and address of the agency location. No agent so terminated shall be permitted to become an agent of the licensee or any other licensee except as provided in Section 12301.4 of the Financial Code."

not subject to the provisions of section 67c of the Bankruptcy Act. Elliott made a timely appeal, properly invoking our jurisdiction under 11 U.S.C. § 47 (1964).

It is contended that the District Court made the following errors:

(1) In concluding from the facts, and as a matter of law, that proceeds from the sale of money orders and checks by Van's Market, as agent for Security Services, Ltd., whether

(a) deposited to a trust account, or

(b) commingled with assets of Van's, constitute trust funds under sections 12300.3 and 12300.4 of the California Financial Code;

(2) In concluding, as a matter of law, that any trust created by sections 12300.3 and 12300.4 is not subject to the provisions of section 67c of the Bankruptcy Act, 11 U.S.C. § 107(c) (1964);

(3) In not finding that no express, constructive, or resulting trust existed under principles of common law;

(4) In not concluding, as a matter of law, that any statutory trust created by sections 12300.3 and 12300.4 should be treated as a statutory lien for application of federal bankruptcy laws;

(5) In not concluding, as a matter of law, that any such trust so created is merely a state-created priority and invalid pursuant to section 64a(5) of the Bankruptcy Act, 11 U.S.C. § 104(a)(5) (1964).[7]

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[7] "(a) The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be . . .

"(5) debts owing to any person, including the United States, who by the laws of the United States in[1] entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law: . . . ."

"[1]So in original. Probably should read 'is'.]"

There are actually two amounts to which we must direct our consideration, (1) the $2,014.99 on deposit in Van's bank account prior to the assignment for the benefit of creditors and which represents segregated funds received for money orders sold by Van's as agent for Security; and (2) the balance of the $3,109.16 due to Security, $1,094.17, which was commingled by Van's with its other assets.

As to the identifiable sum of $2,014.99, the District Court made the correct determination in favor of Security's trustee. Although one may become bankrupt, property which is held by him in trust belongs to the beneficiary of the trust. 4 Collier, Bankruptcy ¶70.25-[2] (14th ed. 1964) [hereinafter called Collier]; 3 Remington, Bankruptcy § 1212 (Henderson ed. 1957). Apart from the provisions of the California Financial Code, the segregated amount is corpus of a trust. The bankrupts' written agreement was a valid trust agreement under California law. See Cal. Civ. Code §§ 2221, 2222. While no trust corpus existed as of the time of the agreement, it has been held, in equity, that if parties intend to create a trust at a future time when the corpus comes into being, the trust should take effect at such future time and the equitable interest pass to the beneficiary. I Bogert, Trusts and Trustees § 113, pp. 575-76 (2d ed. 1965). Generally, the question of whether a trust is established is one to be resolved by the application of state law. See *Jaffke v. Durham*, 352 U.S. 280, 281, 1 L. Ed. 2d 314, 77 Sup. Ct. 307 (1957). Although no California court has ruled directly upon the question in a cause involving such an explicit trust agreement as that made by the bankrupts here, the California Supreme Court has written, "A mere promise

to obtain money and thereupon hold it in trust does not create a trust *until it is at least so far executed that the money has been obtained in accordance with the promise." Molera v. Cooper,* 173 Cal. 259, 262, 160 Pac. 231 (1916). (Emphasis added.) See also 89 C.J.S. Trusts § 24, p. 741, and § 151, pp. 1064, 1068 (1955); Restatement (Second), Trusts § 30 (1959). From the quoted language, it must be inferred that California courts would hold, under the terms of the explicit agreement here, that a trust actually came to be established upon the receipt of those corpus funds which were so clearly anticipated in the agreement precisely defining their trust quality and manner of handling. Furthermore, even had there been no written agreement, the relationship of Security and Van's as principal and agent would seem to have required the impressing of a constructive trust upon funds received by the agent from the sale of his principal's property and retained by the agent in segregated identity. See *Rodes v. Shannon,* 222 Cal. App. 2d 721, 725, 35 Cal. Rptr. 339 (1963); *Spector v. Miller,* 199 Cal. App. 2d 87, 95, 18 Cal. Rptr. 426 (1962); *Darrow v. Robert A. Klein & Co.,* 111 Cal. App. 310, 295 Pac. 566 (1931); Cal. Civ. Code § 2322. Therefore, as to the $2,014.99, in existence and clearly identified, the trustee of Security's estate is entitled to the fund.

As to the remaining $1,094.17, commingled with other money, our determination is fraught with more difficulty. Under the provisions of the California statute all assets of Van's would be impressed with a trust in favor of Security in an amount equal to the aggregate funds received from the sale of the checks and money orders and the trust would remain until payment of the amount due to Security. Cal. Fin. Code

§ 12300.3. By impressing a trust on all assets of the agent, the statute would relieve check and money order principals from the burden of tracing commingled funds. Generally such burden falls upon the beneficiary of a trust. *In re J. M. Acheson Co.*, 170 Fed. 427 (9th Cir. 1909). As Collier has written:

> "The basic idea of the trust doctrine as applied in bankruptcy is a fair and reasonable identification of the property or fund so as not to harm other creditors. It is not enough, therefore, to show merely that the funds or property came into the bankrupt's hands or went into the bankrupt's business or, by the better view, even that the funds or property are contained somewhere within the bankrupt's estate. If the trust fund or property cannot be identified in its original or substituted form, the *cestui* becomes merely a general creditor of the estate, for the prevailing rule in trusts is that 'a beneficiary who cannot find the trust property has no lien or charge spread over the entire estate of the faithless trustee.'"

4 Collier ¶70.25[2], pp. 1216-18. (Citations omitted.)

In this case, however, the state statute undertakes to dispense with the beneficiary's need to trace. Generally, state law governs the determination of whether a beneficiary has sufficiently identified trust property, but,

> "There is the further question, and this a federal one: what is the distribution contemplated by the Bankruptcy Act in the situation at bar? State trust law must not be allowed to pervert or override the distributive provisions of the Bankruptcy Act. A state rule which purports to fasten a general lien

> on a person's estate in the event of insolvency or a general liquidation must be regarded as a priority in disguise and incompatible with the order of distribution prescribed for bankruptcy. The adoption of § 64a(5) and § 67c of the Bankruptcy Act was intended to make clear that state rules of priority of distribution must yield in bankruptcy cases to that prescribed by the Act."

4 Collier ¶70.25[2], pp. 1224-25. In an early case, after recognizing that under applicable state law the owner of a trust fund was entitled to a preference as to the entire body of the estate of an insolvent trustee when the trustee had mingled the trust fund with his own property, the court held that federal bankruptcy law could not allow such a preference and that the beneficiary, unable to trace the trust property, must share in the estate on the same basis as general creditors. *John Deere Plow Co. v. McDavid,* 137 Fed. 802, 812 (8th Cir. 1905). Since the time of that decision, Congress has made even clearer its intent that state law shall not be permitted to confer preference on one class of the creditors of one adjudged a bankrupt under federal law, even though the state may have the highest public purpose in attempting to do so. See, *e.g.,* 2 U.S. Code Cong. & Ad. News 1973 (1952). So it is that section 64 of the Bankruptcy Act eliminates all state-created priorities save one (rent). 11 U.S.C. § 104 (1964). And statutory liens not accompanied by "possession of" or by "levy upon" the property subject to lien before the filing of the petition in bankruptcy are invalidated by

section 67c(2) of the Bankruptcy Act. 11 U.S.C. § 107-(c)(2) (1964).

If state law is contrary to federal bankruptcy law, the state law must yield.[8] Giving effect to the provisions of section 12300.3, which would impress a trust upon commingled funds, would open the door to state creation of priorities in favor of various classes of creditors by labeling such priorities as "trusts". This would tend to thwart or obstruct the scheme of federal bankruptcy. It may be true that Congress was aware of statutory trusts when it made its most recent amendments to the bankruptcy law, for courts were previously confronted with state statutory trusts in bankruptcy cases. *E.g., In re Treister & Son, Inc.*, 145 F. Supp. 144 (S.D.N.Y. 1956); *Albert Pick Co. v. Travis*, 6 F. Supp. 486 (E.D.N.Y. 1933). We cannot believe, however, that Congress contemplated that if trust funds are commingled with other assets of one subsequently declared bankrupt under federal law, a state statute may impress a trust on all assets of the bankrupt's estate to the extent of the amount due the beneficiary. We find no prior case authority which would have adequately warned

[8]The Constitution of the United States provides that "The Congress shall have Power . . . To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States; . . . ." U.S. Const. Art. I, § 8. The Constitution also provides that the laws of the United States made in pursuance of the Constitution "shall be the supreme Law of the Land; and the Judges in every state shall be bound thereby, any Thing in the Constitution or laws of any State to the Contrary notwithstanding." U.S. Const. Art. VI.

Congress of the possibility of such a result, and we have pointed to direct authority for the opposite conclusion. *John Deere Plow Co. v. McDavid, supra.* We hold that the provisions of section 12300.3 of the California Financial Code, insofar as they would establish a trust on the commingled funds, are in such conflict with the federal bankruptcy scheme that they cannot be given effect in the case at bar. The cause is remanded so as to afford to appellee the opportunity to attempt to trace the sources of the commingled funds.

Affirmed in part, reversed in part.

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IN THE

Supreme Court of the United States

October Term, 1965
No. .....

JERALD S. SCHUTZBANK, as Corporations Commissioner of the State of California,

Petitioner,

vs.

PETER M. ELLIOTT, as Trustee in Bankruptcy of the Estate of VAN'S MARKET, a copartnership composed of KENNETH M. PRICE and WILLIAM R. BABINEAU, Bankrupt,

Respondent.

REPLY TO PETITION FOR CERTIORARI.

Respondent respectfully offers the following considerations in response to the petitioner's Petition for Writ of Certiorari:

Statement of Facts.

Petitioner's Statement of Facts is erroneous in part in that it contains petitioner's conclusions such as "Van's held in trust funds received in the sale of Security money orders" and "it was obliged to hold in trust for Security the sum of $3,109.16."

The facts are accurately set forth in detail in the opinion of the Circuit Court of Appeals (*Elliott v. Bumb*, 356 F. 2d 749) on pages 750 and 751.

It is felt that it should be pointed out that *petitioner is in no way aggrieved by the ruling of the United States Court of Appeals for the Ninth Circuit.* As pointed out by the Court of Appeals (*Elliott v. Bumb,* 356 F. 2d 749) in footnote 3 on page 751 of that decision:

> "The Corporations Commissioner of the State of California asserts no claims to the funds held by appellant nor to the funds held by the Credit Managers Association, but as it is charged with the responsibility of enforcing the Check Sellers and Cashers Law, Cal. Fin. Code §§ 12000 et. seq., it is thus concerned with the interpretation placed upon said law by this Court".

If this Honorable Court were to grant petitioner's Petition, as he requests, the only party who would stand to gain thereby would be the appellee below, A. J. Bumb, *who is not before this Court.*

It is therefore respectfully submitted that petitioner is not the proper party to seek a Writ of Ceriorari.

Petitioner's Alleged Reasons for Granting the Writ.

It is respectfully submitted that petitioner has failed to state any grounds for granting its petition under Rule 19 of the Rules of this Honorable Court. It is submitted that the Ninth Circuit Decision is not in conflict with any other Court of Appeals but on the contrary is in accord with other circuits and with the decisions of this Honorable Court and is not in conflict with any state or territorial law. It is obvious that no other Court of Appeals could decide the exact question as decided by the Ninth Circuit, as it was confronted

with a California statute which was struck down as being in conflict with the Federal Bankruptcy Law. However, respondent will endeavor to answer each specific point raised by petitioner in his petition.

Petitioner claims "there is nothing in the Bankruptcy Law which generally requires that there be a specific tracing before a trust beneficiary can be made whole". This is not a true statement of what, it is submitted, is a well settled principle of bankruptcy law.

As stated by the author in Vol. 4 Collier on Bankruptcy §70.25(2), at pages 1216-18:

> "The basic idea of the trust doctrine as applied in bankruptcy is a fair and reasonable identification of the property or fund so as not to harm other creditors. It is not enough, therefore, to show merely that the funds or property came into the bankrupt's hands or went into the bankrupt's business or, by the better view, even that the funds or property are contained somewhere within the bankrupt's estate. If the trust fund or property cannot be identified in its original or substituted form, the cestui becomes merely a general creditor of the estate, for the prevailing rule in trusts is that 'a beneficiary who cannot find the trust property has no lien or charge spread over the entire estate of the faithless trustee' ".

Even the Internal Revenue Code, which provides for a trust in favor of the United States for withholding taxes does not dispense with the requirement that the beneficiary trace the trust property into specific property in the hands of a trustee in bankruptcy.

Title 26 United States Code, Section 7501(a) provides:

> "Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose".

In the case of *Hercules Service Parts Corp. v. United States* (6th Cir., 1953), 202 F. 2d 398, the Court said, in discussing Section 7501(a) (Section 3661 under the 1939 Code):

> "It is the general rule that *a trust cannot be impressed* for the benefit of the cestui que trust *unless the trust property is identified or the corpus of the trust is traced into some specific fund* or thing into which the original trust property has passed in some form. The Congress in Section 3661, when it provided in effect that any person required to collect or withhold any internal revenue taxes is a trustee for the amount of such taxes, did not dispense with the test for the recovery of diverted trust funds. Here the diverted trust funds are not identified and no evidence exists that the assets of the debtor were augmented by the payments". (Emphasis added).

Section 64 of the Bankruptcy Act was amended by Congress in 1938 to do away with all state created priorities save one, rent owing a landlord.

As stated in Vol. 3 Collier on Bankruptcy §64.01 at page 2053:

> "The most extensive change in Section 64 occurred in what under the 1938 Act is the fifth and last class of prior claims—Under this clause persons entitled to priorities under state laws are no longer entitled to prior claims in bankruptcy, except in case of rent; under the corresponding clause of the 1898 Act they were. The change was made in view of supernumerous additions to priority by state legislation, often in conflict with the policy of the Bankruptcy Act".

Collier goes on to say in footnote 27 on pages 2053 and 2054:

> "Regarding this change, it was said in the Analysis of H. R. 12889, 74th Cong., 2d Sess. (1936) 201: 'We have deleted all state priorities except in the case of a landlord—'for like reasons of policy, we have excluded, as indicated, all other state priorities. The necessity for so doing is obvious; many estates have been consumed, to the exclusion of creditors, by the ever-increasing classes of state priorities' ".

The Court of Appeals below accurately appraised the situation by holding on page 755 of that decision (*Elliott v. Bumb, supra*):

> "Giving effect to the provisions of section 12300.-3, which would impress a trust upon commingled funds, would open the door to state creation of priorities in favor of various classes of creditors by labeling such priorities as 'trusts'. This would tend to thwart or obstruct the scheme of federal bank-

ruptcy. It may be true that Congress was aware of statutory trusts when it made its most recent amendments to the bankruptcy law, for courts were previously confronted with state statutory trusts in bankruptcy cases. *E.g., In re Treister & Son, Inc.*, 145 F. Supp. 144 (S.D.N.Y. 1956); *Albert Pick Co. v. Travis*, 6 F. Supp. 486 (E.D.N.Y. 1933). We cannot believe, however, that Congress contemplated that if trust funds are commingled with other assets of one subsequently declared bankrupt under federal law, a state statute may impress a trust on all assets of the bankrupt's estate to the extent of the amount due the beneficiary. We find no prior case authority whoch would have adequately warned Congress of the possibility of such a result, and we have pointed to direct authority for the opposite conclusion".

Conclusion.

Petitioner, in his conclusion, states that the California Financial Codes in question were designed to preserve the integrity of trust funds rather than to give the check seller and casher priority in the general assets of the agent.

It is submitted that to give credence to petitioner's position could only result in giving priority in the general assets of the agent. He would have the so-called "trust" imposed upon the agent's stock in trade, fixtures or other assets which have no relation whatsoever to the original proceeds from the sale of money orders and checks. As stated by the California Supreme

Court in the case of *Bank of America v. Bowden,* 46 Cal. 2d 863:

> "One of the purposes of the legislature in enacting certain provisions of that law which are here involved was to safeguard from the general creditors of the licensed check seller—the funds paid."

For the foregoing reasons, it is respectfully submitted that the Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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